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No. 83

In the Supreme Court of the United States

October Term 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

MARGARET R. PHIPPS, RESPONDENT

CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE TENTH CIRCUIT

BRIEF OF MARGARET R. PHIPPS, Respondent.

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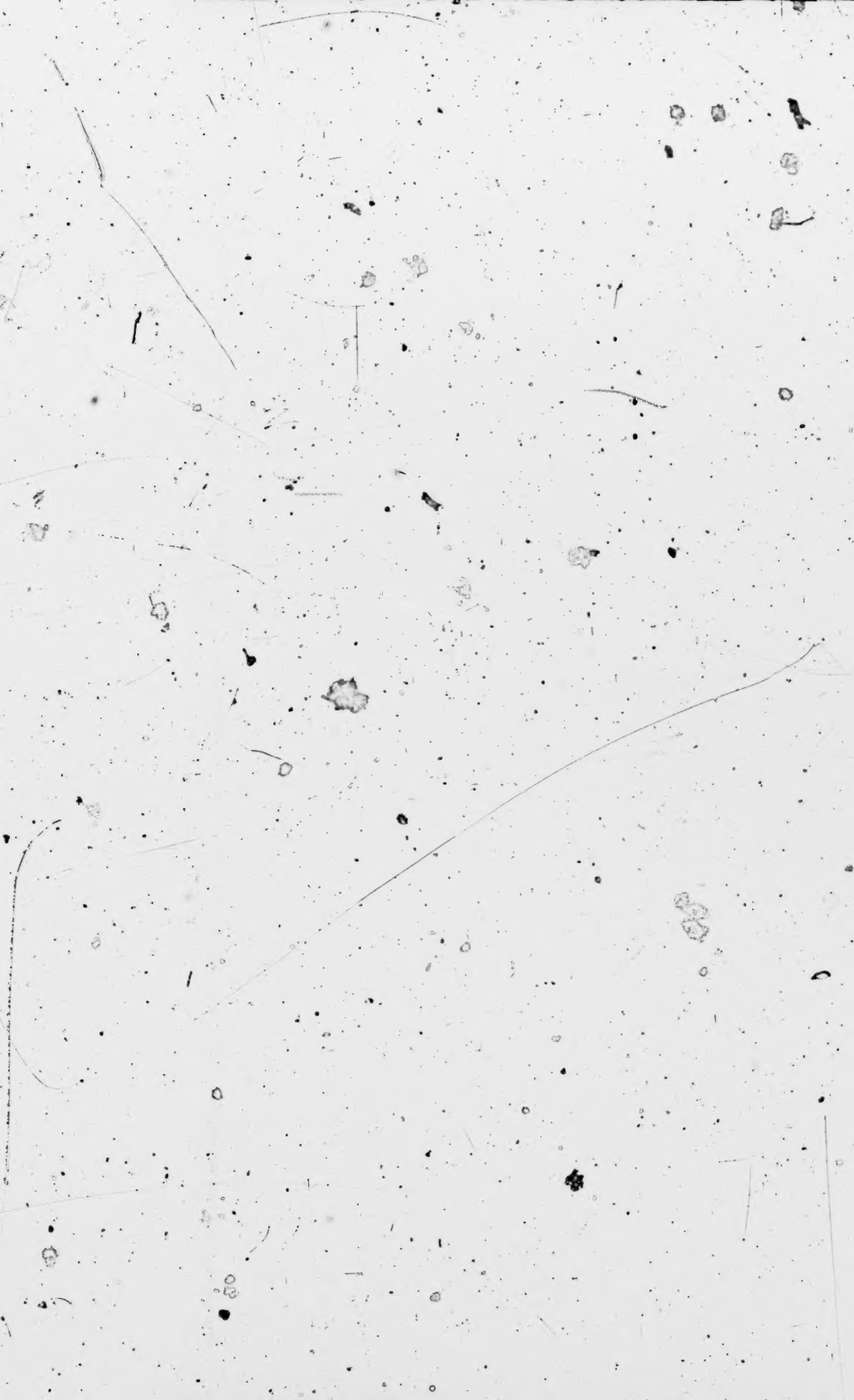

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BRIEF OF MARGARET R. PHIPPS, Respondent.

The respondent, Margaret R. Phipps, under authority of the rules of this Honorable Court, files this her brief on certiorari to review the judgment of the Circuit Court of Appeals for the Tenth Circuit entered in this case.

OPINIONS BELOW

The opinion of the Tax Court. (R. 13-23) is reported at 8 T. C. 190, and the opinion of the Circuit Court of Appeals (R. 30-37) is reported at 167 F. 2d 117. Certiorari was granted by this Court on October 11, 1948.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 19, 1948 (R. 38). The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

STATEMENT OF THE CASE

In 1937, the Respondent received cash distributions from the Nevada-California Electric Corporation upon stock owned by her, in the total amount of $18,480.00, of which $8,992.28 was paid out of current earnings for the year 1937. This payment, together with corresponding payments to other stockholders, absorbed the entire earnings and profits for the year 1937. The question is whether or not the remainder of $9,487.72, which was not paid out of current earnings, was a taxable dividend. (R. 10-11.)

On December 1, 1936, the Nevada-California Electric Corporation completely liquidated five wholly-owned subsidiary corporations, the liquidations being ones upon which no gain or loss was recognized under Section 112(b)(6) of the Revenue Act of 1936. On such date the subsidiaries had earnings and profits accumulated since February 28, 1913, as follows (R. 11-12):

	ACCUMULATED EARNINGS AND PROFITS	
	(Deficit)	(Surplus)
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		90,362.77

As of December 31, 1936, the parent company had accumulated earnings and profits (since February 28, 1913) in the amount of $2,129,957.81 computed without regard to the accumulated earnings and profits (whether surplus or deficit) of the liquidated subsidiaries, without regard to gain or loss to the parent upon such liquidations, and without regard to prior operating profits or losses of such subsidiaries (R. 12).

If as a result of the tax-free liquidation of the five above listed subsidiaries the accumulated earnings and profits accounts of the parent and the one subsidiary as of December 31, 1936, cannot be reduced by the amount of the deficits in the earnings and profits accounts of the other four subsidiaries, then the parent would have had a surplus at the beginning of 1937 available for payment of dividends and the sum of $9,487.72 paid to respondent (and similar payments to other stockholders) would constitute a taxable dividend. This is the contention of the Commissioner, the Petitioner herein.

But if the earnings and profits accounts of the five liquidated subsidiaries must be combined with the corresponding account of the parent, i.e., the surplus of the one subsidiary credited and the deficits of the four charged to the parent's accumulated earnings and profits account, then on December 31, 1936, the parent company would not have had any surplus in accumulated earnings and profits, but would have had a deficit. If this be so, then the sum of $9,487.72 paid to respondent was paid neither out of current earnings for 1937 nor out of accumulated earnings and hence was not a taxable dividend, but was a payment out of the corporation's capital. This is the contention of the taxpayer, the respondent herein, and the Tax Court (R. 23)[1] and the Circuit Court of Appeals (R. 32) so held.

SUMMARY OF ARGUMENT

The sole issue in this case is whether, on the one hand, the earnings and profits accounts of all five liquidated subsidiaries should be combined with the parent's earnings and profits account, or whether, on the other hand, the surplus of one subsidiary should be included but the deficits of the other four should be excluded, in determining the earnings and profits of the parent after such liquidation.

[1] The fact that the decision of Judge Disney was not reviewed by the whole Tax Court does not affect the validity and authority of the decision as intimated by Petitioner. *Sisto Financial Corporation v. Commissioner*, 149 F. 2d 268; *Kennedy Name Plate Co. v. Commissioner*, (CCA-9, decided Oct. 28, 1948).

The principle (known as the *Sansome* rule) that a non-taxable reorganization or liquidation does not toll the lives of the constituent corporations as continued ventures, stated in *Commissioner vs. Sansome* (CCA-2, 1932), 60 F. 2d 931, certiorari denied, 287 U. S. 667, requires not only as a matter of law, but of sound income tax accounting, that the accounts of predecessor constituent corporations be combined and as so combined become the accounts of the emerging or parent corporation. With respect to the earnings and profits accounts of such predecessor companies it makes no difference whether these show a surplus or a deficit; the earnings and profits account of the emerging or parent company is the sum of all surpluses reduced by all deficits.

The correct application of the *Sansome* rule does not open the door to tax avoidance or evasion.

ARGUMENT

The use of corporate reorganizations in the early years of the income tax laws to bring about realizations of losses and gains which were, in a sense, artificially produced, and not the natural result of the operation of the business involved, was recognized by Congress and it decided to discourage manipulations of this type by requiring the participants to postpone any tax effect (advantageous or otherwise) until some event (such as sale of assets) produced a loss or gain which could be accepted as in the normal course of the business of the entire enterprise.

For that reason Congress said that in such transactions neither loss nor gain should be recognized at the time the transaction occurred, and emphasized the factor of continuity of the business venture by providing that the assets of the liquidating company should be set up on the books of the acquiring company at the same tax basis as appeared on the books of the liquidating comp . . . (Revenue Act of 1936, Sections 112(b)(6) and 113(a)(15).)[1] When the acquiring company sold the assets in the future it would incur

[1] Appendix, p. 43.

the same amount of loss or gain as the liquidating company would have incurred had it retained the assets itself, and that amount of loss or gain would at that time be entered in the earnings and profits account of the acquiring company.

But the *Sansome* rule recognizes the fact that the provision made by Congress for accounting for loss or gain on the sale of the assets of the group involved in the business venture as though the inter-corporate transactions had not occurred, made no provision for the disposition of the earnings or losses made or suffered in the management and operation of these assets. The *Sansome* rule preserves consistency in the tax treatment of the entire enterprise in requiring the assets of the liquidating company to go over to the acquiring corporation without tax effect, and that earnings and profits (whether surplus or deficit) should go over unchanged.

The rule is supported both by the courts and by the logic of sound income tax accounting principles.

1. Upon the liquidation of the five wholly-owned subsidiary corporations under section 112(b)(6) of the Revenue Act of 1936, the parent corporation, is, for income tax accounting purposes, considered a continuation of the liquidated companies, and the assets and earnings and profits accounts of the liquidated companies are transferred to and merged with the corresponding accounts of the parent.

This rule was first stated in a decision of Judge Learned Hand of the Second Circuit Court of Appeals in the case of *Commissioner v. Sansome* (July 26, 1932), 60 F. 2d 931, certiorari denied 287 U. S. 776.

In the *Sansome* case, A Company sold out all its assets to B Company, both organized under the laws of New Jersey; the new company assumed all liabilities and issued its stock to the stockholders of A Company. The only change was that the new company's charter gave it broader powers. The latter made no profits and declared a dividend, claimed to be a liquidating dividend, but the court held that since the transaction was non-taxable under Section 202(c)(2) of

the Revenue Act of 1921, one of the so-called reorganization provisions of the statute, the identity of the enterprise continued unchanged by the reorganization with the result that the surplus in earnings and profits of the old company remained as surplus in earnings and profits available for dividends. The Court said (p. 933):

> "Hence we hold that a *corporate reorganization which results in no 'gain or loss' . . . does not toll the company's life as continued venture* under section 201 and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation." (Emphasis ours).

The Supreme Court has approved this view of the *Sansome* rule:

Commissioner v. Munter (May 5, 1947) 331 U. S. 210, 213, 67 S. Ct. 1175, 1176[1]:

> "Relying upon the rule of *Commissioner v. Sansome*, 60 F. (2d) 931, *which, for tax purposes, treats a reorganized corporation as but a continuation of its predecessors*, the Tax Court determined that the new corporation acquired all the earnings and profits of its predecessors in 1928." (Emphasis ours.)

And at page 215:

> "Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws governing reorganizations."

Commissioner v. Wheeler (March 26, 1945) 324 U. S. 542, 546, 65 S. Ct. 799, 802:

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[1]The Circuit Court of Appeals had held that because of the introduction of new money and new stockholders the continuity of life of the venture had been destroyed so that the *Sansome* rule would not apply, citing Campbell v. United States, 144 F. 2d 177. The Supreme Court said: "We granted certiorari because of an alleged conflict with the *Sansome* rule. . . . In the state of the record we find it necessary to decide no more than whether the distinction of the *Sansome* rule made by the Campbell case is correct," and held that the rule applied but that more evidence was needed to show how much of the earnings and profits had actually passed to the new company.

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability but shall be taken account of later. Sec. 112, 113. *It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits.* Compare *Commissioner v. Sansome*, 60 F. (2d) 931. * * *" (Emphasis ours.)

The rule as thus stated by the Supreme Court, has been recognized many times in the last sixteen years by the Federal Courts and the Board of Tax Appeals. The following direct quotations are all from cases involving the application of the rule to tax-free corporate reorganizations or liquidations within the meaning of the Internal Revenue Code and applicable Revenue Acts:

United States v. Kauffman, (CCA-9th, Jan. 23, 1933) 62 F. 2d 1045, 1047:

> "In that case [Sansome] it was held that a reorganization of a corporation whereby the stockholders of an old company received stock of a new corporation in exchange therefor, wherein the stockholders were not taxable for a gain or loss under section 202(c)(2), *supra*, was not such a change in corporate identity as prevented the new company from being *considered as a continuing venture* under section 201 of the Revenue Act of 1921 (42 Stat. 228) and that whatever were earnings of the original corporation continued to be such in the hands of the new corporation." (Emphasis ours.)

Georday Enterprises, Ltd. v. Commissioner, (CCA-4, Mar. 9, 1942), 126 F. 2d 384, 389:

> "The meat of the Sansome case is found in a statement by Circuit Judge Learned Hand * * * 'Hence, we hold that a corporate reorganization which results in no "gain or loss" * * * does not toll the company's life as continued venture * * * and that what were "earnings or profits" of the original, or subsidiary, company remain, for purposes of distribution, "earnings or profits" of the successor, or parent, in liquidation.'"

Reed Drug Co. v. Commissioner, (CCA-6, Aug. 28, 1942), 130 F. 2d 288, 290:

> "Such corporate transactions * * * do not break the continuity of the corporate life."

Robinette v. Commissioner, (CCA-9, Mar. 19, 1945), 148 F. 2d 513, 516:

> "The earnings and profits of Cole-French Company, in existence when liquidation occurred, did not disappear. Either the subsidiary or the parent company had them. * * * The parent completely took over the subsidiary. There is *complete identity* of the corporations." (Emphasis ours.)

George F. Baker v. Commissioner, (CCA-2, Jan. 6, 1936), 80 F. 2d 813, 815, (affirming 28 B.T.A. 704):

> "It (parent company) had not in fact earned all of this amount itself, *but the combined taxable earnings of itself and of the five predecessor companies* made up that amount. As the taking over of those five companies by Consolidated was a nontaxable reorganization, their earnings had the same taxable status after the reorganization as before. They became the post February 28, 1913, earnings and profits of Consolidated so far as taxation is concerned. *Commissioner v. Sansome* (CCA), 60 F. (2d) 931." (Emphasis ours.)

Estate of Howard McClintic (June 25, 1942), 47 B.T.A. 188, 202:

> "The Sansome decision is predicated on the thought that a tax-free exchange does not operate to 'break the continuity of the corporate life,' and that therefore when a reorganization 'does not toll the company's life as continued venture' the earnings of the 'original, or subsidiary, company remain * * * "earnings or profits" of the successor, or parent.' This is because such reorganizations do not 'result in any "gain or loss" to the shareholder participating in them.'
>
> "Thus when the shareholders in McClintic-Marshall received stock of Union in lieu of a portion of what their McClintic-Marshall stock had theretofore represented there was a continuity of the corporate

life of the McClintic-Marshall-Union corporate enterprise."

In the instant case the dissolution of the five subsidiaries and the transfer of their assets to the parent corporation was a non-taxable transaction. Consequently the lives of the liquidated corporations were not "tolled" but continued as part of the life of the parent corporation with which they were consolidated. One of the results of this merger is that the earnings and profits accounts of the dissolved corporations become part of the earnings and profits account of the parent corporation, the taxpayer and respondent herein.

2. Under the continued venture principle of the Sansome case, the four subsidiaries having deficits in their earnings and profits accounts must be treated in the same manner as the one subsidiary having a surplus in its earnings and profits account.

The *Sansome* rule was thus interpreted in the case of *Harter v. Helvering*, 30 B.T.A. 572, (CCA-2, July 8, 1935), 79 F. 2d 12, in which Judge Learned Hand again rendered the decision for the same court that had considered the original *Sansome* case.

In the *Harter* case there were two separate reorganizations. The first reorganization was a merger of Philadelphia Paper Manufacturing Company and Fibre Container Company, each of which had a surplus in its earnings and profits account. The emerging corporation was named New Company. As to this merger, the opinion states (p. 13):

> "When the Philadelphia Paper Manufacturing Company and the Fibre Container Company merged on June 30, 1923, no gain was 'recognized' to the shareholders, for it was a 'reorganization' under section 202(c)(2) of the Revenue Act of 1924 (42 Stat. 229), and section 203(b)(2) of the Revenue Act of 1926, 26 USCA Sec. 934 (b)(2). A *consequence* of this is that for purposes of allocating dividends under section 201(b) of the Revenue Act of 1926, 26 USCA Sec. 932(b), against earnings before and after March 1, 1913, the surplus is regarded as unchanged. The Commissioner proceeded on the assumption that the shares issued by the New Company, $3,164,750, 'impounded' a corresponding amount of surplus and

> left for distribution as dividend only the bookkeeping surplus, $1,692,384.34. We have decided otherwise, Commissioner v. Sansome, 60 F. (2d) 931, and the Ninth Circuit agrees. U.S. v. Kauffman, 62 F. (2d) 1045. *Thus the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both, $4,307,134.34 . . .*" (Emphasis ours.)

The second reorganization involved in the case was a consolidation of New Company with Boxboard Company. New Company had a substantial surplus in its earnings and profits account but Boxboard had a deficit of $17,388.95. The Court held that upon the merger of New Company and Boxboard Company, the earnings and profits account of the emerging company, which was Boxboard, was not the surplus of New Company undiminished by the deficit of Boxboard Company, but was the contrary, i.e., the surplus of New Company reduced by the deficit of Boxboard Company. Referring to the last sentence in the above quotation from its opinion, the Court expressly pointed out the manner in which this result was reached (p. 13):

> "*Again when in April 1926, the New Company consolidated with the Boxboard Company, the same result ensued; for purposes of allocation the capital was $516,945, and the surplus, $4,289,745.39 . . .*" (Emphasis ours.)

Hence, in the *Harter* case the Court held, as to the first reorganization, that the surplus of the emerging new company was the difference between the assets of both the old companies and the capital shares of both. Then, as to the second reorganization, the Court expressly declared in applying the *Sansome* rule to a merger of a surplus company and a *deficit* company, *the same result ensued* as in the case of merger of surplus companies, to-wit: the successor or emerging company has assets consisting of the total of both companies' assets, and has a surplus or deficit in its earnings and profits account determined by subtracting the combined capital from the combined assets. As a result of this rule, each constituent company's earnings and profits account continues to exist in the corresponding ac-

count of the emerging company,—a surplus in the earnings and profits account is not converted into additional capital, nor is a deficit in the earnings and profits account eliminated by a reduction of capital.

The Court's computations are more easily visualized by the following table:

	Net Assets		Capital		Earnings & Profits
New Company (before merger)	$a	minus	$x	equals	$4,307,134.34 (surplus)
Boxboard Company (before merger)	$b	minus	$y	equals	—(17,388.95) (deficit)
One Company (Upon merger)	$(a+b)	minus	$(x+y)	equals	$4,289,745.39 (surplus)

Petitioner attempts to distinguish the *Harter* case as one involving the carrying forward of a surplus, saying there is not even dicta supporting the view that the deficit of the predecessor or subsidiary should enter into the computation of the earnings and profits account of the parent. On the contrary the case is direct authority for the proposition that a deficit must enter into the computation. The *method* of the computation expressly set forth by the same Judge who first enunciated the *Sansome* rule in the *Sansome* case *requires* that deficit companies and surplus companies be treated alike, and that existing surpluses and existing deficits be combined in the emerging company. By this method the balance, whether surplus or deficit, in the emerging company's earnings and profits account has to be the same, irrespective of which company emerges from the standpoint of corporation law.

The *Sansome* rule was applied to a company having a *deficit* in its earnings and profits account by the Commissioner and approved by the Tax Court in the case of *Senior Investment Company v. Commissioner* (Jan. 15, 1943) 2 T. C. 124.

In that case the taxpayer company organized a subsidiary corporation to which it transferred a portion of its assets in exchange for all of the stock of the subsidiary, i.e., a tax-free reorganization. The taxpayer company had a large deficit and in the reorganization a portion of this was allo-

cated to the subsidiary. After the transaction was completed, the question arose, under the Revenue Act of 1936 which assessed a tax on undistributed profits, as to whether the taxpayer company had a deficit in its earnings and profits account, the Commissioner's contention being that a greater amount of such deficit was allocable to the subsidiary. The Court said (p. 137):

> "It is the rule that, where the assets of one corporation pass to a successor corporation in a tax-free reorganization, the accumulated earnings and profits of the old corporation pass to the successor *with the same status* and are available for the payment of dividends by the latter, Commissioner v. Sansome, 60 Fed. (2d) 931; certiorari denied 287 U.S. 667; United States v. Kauffman, 68 Fed. (2d) 1045; Reed Drug Co. v. Commissioner, 130 Fed. (2d) 288; Helen V. Crocker, 29 B.T.A. 773; and that where only part of the assets are so transferred, it is proper to make an allocation of the earnings and profits between the two corporations in proportion to the assets transferred and the assets retained.
>
> "The Respondent (Commissioner) questions the Petitioner's claim that it is a deficit corporation; *but he makes no contention that the principles of the foregoing cases do not apply to the inheritance or absorption of a deficit.* * * *" (Emphasis ours.)

The Tax Court then held that whether the basis of allocation of the deficit accorded with the taxpayer's contention or the Commissioner's was immaterial since in either event a sufficient deficit would be retained by the taxpayer to give it the desired credit.

Although the statute and precise issue involved in the *Senior Investment Company* case, *supra*, are different from the statute and precise issue involved in the instant case and in the Sansome case, nonetheless the Tax Court has regarded the *Senior* case as being authority for application of the *Sansome* rule to an issue quite similar to the instant case.

In *Stella K. Mandel* (Sept. 10, 1945), 5 T. C. 684, involving a tax-free split-off reorganization in which it was conceded

that the *Sansome* rule applied, the issue was the proper allocation of surplus between old and new companies for the purpose of determining whether or not distributions of the new company were from accumulated earnings or profits and hence taxable as dividends. The statute involved in the *Mandel* case was the same as the statute involved in the instant case. In sustaining the Commissioner's method of allocating surplus to the successor company, the Tax Court relied upon the *Senior* case as follows (p. 688):

> "The Petitioner's theory of allocation raises a question which does not appear to have been heretofore specifically presented and settled in the decided cases, though inherent in a number of them. However, as a general proposition, the method of allocation urged by the respondent finds abundant support in decided cases. See *Barnes v. United States*, 22 Fed. Supp. 282; *Estate of Howard H. McClintic*, 47 BTA 188 (appealed CCA-3, settled by stipulation in compromise); *Senior Investment Corporation*, 2 T. C. 124. In the instant transaction it clearly appears that there is a substantial identity of the old company in the several corporations involved and that there is a continuity of proprietary interests so as to make the rationale of the above cases applicable."

And in the earlier case of *Crocker v. Commissioner* (Jan. 17, 1934), 29 B.T.A. 773, the Board said:

> "It is also true that it is merely stipulated that the surplus of the three was sufficient to pay the dividends so that *it may be that one of them had a deficit.* If so, petitioners have failed to this extent in their proof. *But we do not think that such a fact, if true, makes any difference.* If the successor corporation had a surplus inherited from all its predecessors sufficient to pay the dividends, it matters not in what proportions it was contributed." (Emphasis ours.)

In the course of this litigation Petitioner has cited but one case which he asserts supports his claim that earnings and profits accounts showing a deficit can not be combined under the *Sansome* rule: *Cranson v. United States* (CCA-2, Jan. 24, 1945) 146 F. 2d 874, certiorari denied, 326 U.S. 717.

In the *Cranson* case, a parent company (The Honolulu Oil Corporation, Ltd.) liquidated (tax free) three wholly owned subsidiaries on August 31, 1936, when the subsidiaries had substantial deficits.

The statute involved in the *Cranson* case was the same as in the instant case—the Revenue Act of 1936. Section 115(a)(b) of that Act[1] provides that corporate distributions shall be considered as paid first from the earnings of the current year, and then from earnings accumulated since February 28, 1913. To the extent that there are net earnings of the current year, the distribution is a taxable dividend, even though there are no accumulated earnings from prior years, or even if there is a deficit in prior years. In the instant case this was recognized and the taxpayer conceded (R. 11) and the Tax Court found as a fact (R. 14), that the distributions in the year 1937 were taxable to the extent of the earnings of that year. In the instant case the sole issue is the effect of the subsidiaries' deficits upon *accumulated* earnings and profits. In the *Cranson* case, however, the taxpayer insisted that the deficits of the subsidiaries should be applied to reduce not the *accumulated* earnings prior to 1936, but the *current* earnings of 1936.

The Court said (p. 871):

> "If Honolulu itself had at the beginning of 1936 the same operating deficit, the deficit could not have been deducted."

and later in the opinion (p. 872):

> "The equation of operating deficit for tax purposes is the loss sustained within the taxable year. As to the alternative contention of the appellant here that if the operating deficits do not diminish the earnings, the losses sustained in the liquidation would diminish earnings, there has been no showing that any of the loss was incurred in the tax year in question. Furthermore, it is apparent that appellant has not maintained its burden of proof that any of the deficits occurred in the tax year 1936. * * * It is hence

[1] Appendix, pp. 43-44.

not before us to consider whether any such deficits would be deductible from the profits of the parent corporation if they had occurred in the tax year 1936.

"Whether or not the parent company suffered losses in the tax years prior to 1936, if there be corporate earnings or profit in that year the Revenue Act of 1936 provides that distributions to the stockholders in that year are deemed to be from its most recently accumulated earnings or profits for that year, without regard to the fact that they are earned in that portion of the year after the distribution was made."

It is obvious, therefore, that the Court and the parties were addressing themselves to the question as to whether the deficits of the subsidiaries were deductible from *current earnings* of the parent for the year in which the distributions were made. That question is not involved in the instant case and was not passed upon by the Tenth Circuit Court of Appeals in its decision herein.[1]

Respondent therefore submits that the *Cranson* case is no authority for petitioner's argument in the instant case.

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[1]Petitioner states in his brief that the total dividend paid by the parent in 1936 amounted to $937,743, and argues that the distribution in 1936 exceeded the 1936 current earnings of $931,553.32 by $6,189.19, and that, as to the latter amount (i.e., 66/100 of 1% of the distribution), the distribution could have been held a dividend only if the parent's accumulated earnings prior to 1936 were not affected by the subsidiaries' deficits. On the basis of this 66/100 of 1% (which as to Mr. Cranson amounted to $2.97) petitioner argues that the court to that extent rendered a decision in conflict with the instant case. The figure of $937,743 as the amount of the dividend is not mentioned in the decision of the Circuit Court of Appeals in the *Cranson* case, and petitioner ascertains the amount by reference to the record in the case of *Lorin A. Cranson v. United States of America*, No. 85, October Term, 1944, of this Court, which is not part of the record of the instant case. Reference to the briefs in Case No. 85 discloses, however, that the entire argument was centered on the question of the right to deduct deficits of the subsidiaries for prior years from the *current* earnings of the parent company for 1936 and no reference was made to the question involved in the instant case. A second case by Cranson, covering distribution in 1938, (32 A.F.T.R. 1640) was, by stipulation of the parties, decided in accordance with the foregoing decision. *Lorin A. Cranson v. United States*, 151 F. 2d 1021.

In the instant case both the Tax Court and the Circuit Court of Appeals approved and applied the *Sansome* rule as applied to deficits in earnings and profits accounts.

The Tax Court held (R. p. 22):

> "After reviewing with care the above authorities we have come to the conclusion that the Sansome and Harter cases are controlling here. The primary principle announced in the Sansome case, and since consistently followed, was that a nontaxable reorganization does not toll the life of the constituent corporations as a continued venture, and it was only the result of that conclusion to add that earnings or profits of an original or subsidiary corporation remained earnings or profits of the successor, or parent, corporation. The venture continues regardless as to whether there had been surplus or deficit in the finances of the constituent corporation; therefore, in our view, the deficit is carried forward into the finances of the resultant corporation, equally with a surplus of any other constituent, and in both cases alike there is effect on the ability to distribute earnings and profits. The petitioner's corporation is merely a prolongation, in reorganized form, of a 'substantial identity' of financial situation and a 'continuity of proprietary interests,' to use the words of the *Mandel* case, *supra*. *No convincing reason appears to differentiate between surplus and deficit in the theory of continued venture.*" (Emphasis ours.)

The Circuit Court of Appeals held (majority opinion, R. pp. 31-32):

> "In a tax-free reorganization of corporations where a parent liquidates a wholly owned subsidiary, taking over its assets subject to their liabilities in complete cancellation and redemption of its issued and outstanding capital stock, or where two corporations merge, the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. It includes a deficit in the earnings or profits account of such company. The earn-

ings and profits accounts of the transferor company, whether consisting of credit balances or deficits, should be reflected in the corresponding accounts of the transferee company and should be taken into account in determining whether distributions subsequently made to stockholders of the emerged company were paid out of earnings or profits or out of capital."

The decisions of the Tax Court and the Circuit Court below correctly interpret and apply the *Sansome* rule in accord with Judge Hand's decisions in the *Sansome* and *Harter* cases. Those cases declared the broad principle that for the purpose of allocating assets between the tax concepts of capital and earnings and profits, the life of a predecessor or subsidiary company is not tolled but is continued in the successor or parent company. Those cases require that the earnings and profits accounts of all the companies, whether reflecting surplus or deficit balances, be combined in that account of the successor or parent. No case has held that deficit balances should not enter into the computation, and in the *Senior Investment Co.* case the Commissioner urged before the Tax Court that a greater amount of that taxpayer's deficit should be attributed to the transferee company.

3. Sound income tax accounting requires that the Sansome rule shall be construed to contemplate the consolidation of the earnings and profits accounts of the subsidiaries and the parent and Congress so intended.

The words "earnings and profits" refer merely to an account; the word "deficit" refers merely to a minus balance in that account; and the word "surplus" connotes simply a plus balance in such account.[1] Neither the capital account nor the earnings and profits account of a corporation stands for or represents any specific assets or any specific property.

[1] In the *Wheeler* case, *supra*, this Court commented on the meaning of the term "earnings and profits," and pointed out that both losses and gains enter into their computation. It follows that losses may exceed gains and the "earnings and profits" account may show a deficit. The *Harter* case, and the *Senior* case, *supra*, both applying the "Sansome" rule, show that the term "earnings and profits" refers to an account by that name which may or may not have a credit balance or surplus.

The capital account reflects that portion of a company's total assets which is represented by the funds paid in by contributing stockholders as "capital." For tax purposes a corporation's capital as reflected by its capital account remains constant (except as it is increased by contributions from, or decreased by distributions to, its stockholders). The gains or losses of the corporation do not increase or decrease "capital."

The earnings and profits account reflects the difference between the corporation's net assets (i.e. assets minus liabilities) and its capital, and is therefore the balancing figures in an equation.[1]

The equation is: net assets (i.e. assets reduced by liabilities) equals capital plus earnings and profits. A company's net assets must always be exactly equal to its capital plus its earnings and profits.

A corporation which has sustained operating losses sufficiently great so that its net assets are less than its capital, thus has a deficit in earnings and profits. Such a corporation does not have any accumulated earnings and profits out of which dividends can be paid until it realizes sufficient earnings to restore such deficit.[2]

[1] Fletcher, Cyclopedia of Corporations, Vol. 11, Sec. 5335: "It may be laid down as a general proposition . . . that the surplus or net profits of a corporation are the difference between the total present value of its assets, after deducting losses and liabilities, and the amount of its capital stock." The earnings and profits account represents "a balance sheet position." Note on instant case in Harvard Law Review, May 1947, p. 826.

[2] "MEANING OF 'ACCUMULATED EARNINGS OR PROFITS.' The statute includes in the term 'dividend' not only distributions out of current earnings or profits, but also distributions out of 'accumulated' earnings or profits (since February 28, 1913). Accordingly, prior to the 1936 Act, any distribution, and since the 1936 Act, the excess of distribution over current earnings, is a taxable dividend only if there exist earnings or profits accumulated after February 28, 1913. *An impairment of fixed or statutory capital occasioned by a deficit must be restored out of subsequent earnings before there can be accumulated earnings or profits available for dividends. The same rule governs impairments of capital surplus or paid-in surplus.*" (Emphasis ours.) Mertens, Law of Federal Income Taxation, Vol 1, Sec. 9.30, p. 461.

If the *Sansome* rule applies to surpluses only it penalizes the corporate group because it does not permit deficits in the earnings and profits accounts of the merging companies to be restored out of the combined earnings of those companies. This illogical result can be readily shown.

Suppose, for example, that a single individual has organized two corporations, contributing $100,000 in cash to each for all of the stock of each company. Suppose, further, that in a given period one corporation earns and retains profits amounting to $25,000, while the other sustains operating losses of $25,000. At this point the one corporation would have a surplus in its earnings and profits account of $25,000, its assets having been increased by profitable operations in that amount; while the other corporation through losses would have reduced its assets by $25,000 and would have a corresponding deficit in its earnings and profits account. The results of these operations for each corporation shown in abbreviated balance sheet form, would be as follows:

	Company A	Company B
Net Assets (i.e. Assets minus Liabilities)	$125,000	$ 75,000
Capital	100,000	100,000
Earnings and Profits—		
Surplus or (Deficit)	25,000	(25,000)
Total—capital and earnings	$125,000	$ 75,000

Suppose, then, these two corporations were merged. Petitioner admits that under the *Harter* case, if B is the company emerging from such a consolidation, then it would be proper to carry forward the surplus in earnings and profits of A into the computation of the earnings and profits account of the new company B. Thus, the earnings and profits account of the two companies after consolidation into B would be zero, since the surplus of A of $25,000 would be carried over to B and would offset B's deficit of $25,000. But Petitioner, attempting to distinguish *Harter*, contends that if A is the company which emerges, then the combined earnings and profits account of these same two companies would not be zero, but would be a *surplus* in earnings and

profits of $25,000. Petitioner argues that although the surplus of A can be combined with B's deficit, yet the deficit of B cannot be combined with A's surplus in computing the earnings and profits of the combined company. Obviously it is of no significance whether A is merged into B or B is merged into A. Whichever company emerges will own the same assets, A's assets plus B's assets, totaling in the example $200,000; and irrespective of which company emerges, the fact remains that the stockholder has a capital investment of $200,000 in the emerging company. Since the combined assets total $200,000 and the combined capital totals $200,000, all the assets represent capital and none represent earnings. Clearly the result is the same whether A or B emerges from the consolidation.

Congress has, over the years, gradually evolved a plan of *tax* accounting to be applied to liquidations under Sec. 112(b)(6)[1] as well as to other rearrangements of corporate relationships where the identity of the business and economic interest continues but under a different form. The rules applicable in 1936, when the transactions here involved occurred, included the following:

1. The loss or gain of the parent on receipt by the parent of the assets of the subsidiary is not recognized for tax purposes at the time of liquidation. (Sec. 112(b)(6).)[2]

2. The assets so received must be entered on the parent's books at the cost shown on the subsidiary's books at the date of liquidation. (Sec. 113(a)(15).)[3]

3. When the assets are subsequently sold gain or loss is then recognized in the amount of the difference between the sale price and the subsidiary's cost and the gain or loss so recognized is then for the first time reflected in the earnings and profits account of the parent. (Sec. 115(l) added by Sec. 501 of the Second Revenue Act of 1940 and made retroactive.)[4]

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[1] Appendix, p. 43.
[2] Appendix, p. 43.
[3] Appendix, p. 43.
[4] Appendix, p. 45.

4. The distribution of assets to the parent on liquidation is not considered a distribution of earnings and profits of any corporation. (Sec. 115(h).)[1]

5. The earnings and profits account of the subsidiary are transferred to the parent and become part of the parent's earnings and profits account. (*Sansome* rule, a rule of judicial construction recognized by Congress.)

The following examples will clearly show that the *Sansome* rule and Sections 112(b)(6), 115(l) and 113(a)(15), are integral parts of the plan of Congress and that without the *Sansome* rule the provisions of the statute produce an illogical and unjust effect. In all of these examples the values and figures used represent sound income-tax accounting figures.

A. We will first consider the case where none of the corporations has had an operating loss and the facts are as follows:

(1) P. Co., the parent, contributed $100,000 as capital for all the stock of each of three companies, A, B and C.

(2) A. Co. realized neither profits nor losses through operations.

(3) B. Co. realized profits of $200,000 through operations.

(4) C. Co. realized profits of $400,000 through operations.

(5) At time of liquidation the fair market value of the assets of each company was $500,000.

Balance sheets of the subsidiaries immediately prior to liquidation will thus be as follows, it being noted that the unrealized appreciation of the assets of companies A and B is not, for income tax purposes, reflected thereon:

[1] Appendix, p. 44.

A. Co.

Assets	$100,000	Capital	$100,000
		Earnings and Profits	
	$100,000		$100,000

Applying the tax accounting rule above stated to the liquidation of A. Co.:

The increase in book value of A's assets from $100,000 to $500,000 is due to appreciation of asset values and not to earnings and profits.

P receives assets worth $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $100,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by the receipt of assets worth $500,000 because the gain is not recognized and there are no earnings and profits in A's accounts to be transferred to P.

No occasion to apply *Sansome* rule.

B. Co.

Assets	$300,000	Capital	$100,000
		Earnings and Profits	200,000
	$300,000		$300,000

The increase in book value of B's assets from $100,000 to $300,000 is due to earnings and profits. The difference between the book value of $300,000 and $500,000 market value is due to appreciation of asset values.

P receives assets of $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $300,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not charged by its receipt of assets worth $500,000 but it will be increased by so much of that amount as represents the earnings and profits of B, namely, $200,000, according to the *Sansome* rule.

C Co.

Assets	$500,000	Capital	$100,000
		Earnings and Profits	400,000
	$500,000		$500,000

The increase in book value of C's assets from $100,000 to $500,000 is due to earnings and profits alone.

P receives assets of $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $500,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $500,000 but it will be increased by so much of that amount as represents the earnings and profits of C, namely, $400,000, according to the *Sansome* rule.

It will be thus seen that where the subsidiaries have not been operated at a loss prior to their liquidation, the correct effect upon P Co.'s earnings and profits account is obtained in all cases either by the operation of the applicable sections of the statute, or by the operation of such sections in conjunction with the *Sansome* rule, or by the operation of the *Sansome* rule alone.

B. We will next consider the case where two of the corporations have operated at a loss and the facts are as follows.

(1) P Co., the parent, contributed $500,000 as capital for all of the stock of each of three companies, X, Y and Z.

(2) X Co. realized neither profits nor losses through operations.

(3) Y Co. realized losses of $200,000 through operations.

(4) Z Co. realized losses of $400,000 through operations.

(5) At time of liquidation the fair market value of the assets of each company was $100,000.

Balance sheets of the subsidiaries immediately prior to liquidation will thus be as follows, it being noted that the unrealized depreciation of the assets of companies X and Y is not, for income tax purposes, reflected thereon:

		X Co.	
Assets	$500,000	Capital	$500,000
		Earnings and Profits	
	$500,000		$500,000

The decrease in book value of X's assets from $500,000 to $100,000 is due to depreciation in asset values and not to operating losses.

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $500,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because its loss is not recognized and there are no earnings or profits in X's accounts to be transferred to P.

No occasion to apply *Sansome* rule.

		Y Co.	
Assets	$300,000	Capital	$500,000
		Earnings and Profits (deficit)	(200,000)
	$300,000		$300,000

The decrease in book value of Y's assets from $500,000 to $100,000 is due to loss of asset value caused by the operating loss (deficit in earnings and profits) to the extent of $200,000, and to shrinkage in asset value to the extent of $200,000.

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $300,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because the loss is not recognized, but its account should be charged with the deficit in the earnings and profits account of Y because otherwise the loss of asset value when the operating expenses of Y consumed $200,000 of assets can never be recouped. It is only by the application of the *Sansome* rule that this inequity can be corrected.

		Z Co.	
Assets	$100,000	Capital	$500,000
		Earnings and Profits (Deficit)	(400,000)
	$100,000		$100,000

The decrease in value of Z's assets from $500,000 to $100,000 is due entirely to operating losses (deficit in earnings and profits).

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $100,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because the loss is not recognized, but its earnings and profits account should be

charged with the deficit in the earnings and profits account of Z because otherwise the loss of asset value when the operating expenses of Z consumed $400,000 of assets can never be recouped. It is only by the application of the *Sansome* rule that this inequity can be corrected.

Failure to apply the *Sansome* rule to subsidiaries having deficits would not only grossly distort the earnings and profits account of the parent but would also produce a corresponding reduction of capital. This can be very simply demonstrated by reference to the foregoing examples. Assume that P. Co., the parent, was organized with $600,000 paid in for its capital stock, and that P. Co. thereupon organized the two above subsidiaries C and Z, paying in $100,000 and $500,000 respectively for the subsidiaries' capital stock. As in the above examples, when the two subsidiaries are liquidated C has a surplus in its earnings and profits account of $400,000 and Z has a deficit in its earnings and profits account of $400,000. The balance sheets of the parent and its two subsidiaries just prior to the liquidations are as follows:

P. Co.

Assets:		Capital	$600,000
Stock of C. Co. (*a* Cost)	$100,000	Earnings and Profits	-0-
Stock of Z Co. (*a* Cost)	500,000		
	$600,000		$600,000

C. Co.

Assets	$500,000	Capital	$100,000
		Earnings and Profits Surplus	400,000
	$500,000		$500,000

Z. Co.

Assets	$100,000	Capital	$500,000
		Earnings and Profits (deficit)	400,000
	$100,000		$100,000

If the *Sansome* rule is applied to C. Co. but not to Z. Co., then the financial structure of P. Co. for tax purposes after the liquidations would be reflected upon a balance sheet as follows:

Assets:		Capital	$200,000
Property of C Co. (@ C's basis)	$500,000	Earnings and Profits (surplus)	400,000
Property of Z Co. (@ Z's basis)	100,000		
	$600,000		$600,000

If the *Sansome* rule does not apply to Z. Co., then upon the liquidations Z's deficit of $400,000 is wiped out and C's surplus of $400,000 is attributed to the parent. In such event the parent's capital must be reduced since the total of the capital account and the earnings and profits account must always exactly equal the total assets. In the example, P's assets after liquidation amount to $600,000. If those assets represent earnings and profits to the extent of $400,000, then only the balance of $200,000 is left to be allocated to capital. Before the liquidations, P. Co. owned $600,000 of assets (stock of C and Z) which exactly equaled the capital with which it started business and which was paid in as capital by its stockholders, none of which represented earnings. After such liquidations P. Co. owns $600,000 of assets (property of C and Z) which exactly equals the capital with which it started business all of which should still represent capital and none of which should represent earnings. But if the *Sansome* rule does not apply to the deficit subsidiary, such $600,000 of assets represent earnings of $400,000 and capital only to the extent of $200,000.[1]

If the *Sansome* rule does apply to both C and Z, then the balance sheet of P. Co. for tax purposes after the liquidations would be:

[1] Such an application of the rule would thus tax as income a distribution of the corporation's capital—a result never intended by Congress.

Assets:		Capital	$600,000
Property of C Co. (at C's basis)	$500,000	Earnings and Profits	none
Property of Z Co. (at Z's basis)	100,000		
	$600,000		$600,000

This would reflect the true economic status of the enterprise.

From the foregoing study of the possible situations which may arise both where corporations are operated at a profit and where they are operated at a loss, we submit that it is evident that the only way in which all situations can be treated equitably is by the application of the *Sansome* rule to both surpluses and deficits in earnings and profits accounts.

Congress has said to the parent company:

(1) If you liquidate a wholly-owned subsidiary, you cannot take for income tax purposes your actual loss on that liquidation, nor do you have to report your actual gain.

(2) You must adopt as a basis for loss or gain the cost basis of the assets as shown on the books of the subsidiary, and if and when you sell any of these assets in the future, you must compute your loss or gain for income tax purposes as the difference between what you receive and this substituted basis.

The effect of these provisions is to place the assets after they have been received by the parent, in exactly the same status as they were in the hands of the subsidiary. There is a complete continuity of asset treatment. The losses and gains on disposition will be the same as though the liquidation had not taken place except that they will be the losses and gains of the parent and not of the subsidiary.

In the *Sansome* and *Hunter* cases, Judge Hand saw the effect of this rule as to non-recognition of loss or gain determined by reference to the transferor's basis, realized that it was based on the theory of continuity of enterprise

and economic interest, and he pointed out that the theory must imply a complete continuity and that to accomplish that the earnings and profits account would have to be carried over in the same condition as it appeared on the books of the subsidiary.

This is what Congress believed when the Senate Finance Committee said, with respect to Sec. 50 of the Second Revenue Act of 1940 providing that unrecognized losses or gains should not decrease or increase earnings and profits, that this provision "is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."[1]

Congress was then amending the statute as to the effect of unrecognized *gains or losses;* the *Sansome* rule had already taken care of surpluses and deficits in earnings and profits accounts and Congress had already approved it. It was bringing into line the handling of losses and gains.

Nowhere in any of the committee reports is there any statement or suggestion that Congress did not think the *Sansome* rule related to both surpluses and deficits in earnings and profits accounts. If it had thought differently, it is incredible that it should not have so stated by express legislation long ago.

The petitioner is confused because he is constantly trying to relate the reasons for or against the *Sansome* rule to alleged attempts to realize the actual losses or gains of the parent company. An examination of the laws and regulations as indicated above clearly shows that when the parent liquidates a wholly-owned corporation, it sacrifices forever any right to compute its loss or gain with reference to its actual cost of the stock of the subsidiary. It takes the subsidiary's base and position and goes on from there. The parent's cost may have been $100,000 for the stock; the assets received may have a fair market value of $500,000, but if the subsidiary's book value for those assets is $200,000,

[1] Sen. Rept. No. 2114, 76th Cong. 3d Sess., quoted at length *infra*, pp. 36-7.

then the parent's basis is $200,000 and that ends the discussion. The actual loss or gain of the parent has no place in this argument.[1]

It follows therefore that any argument on the question of the carrying forward of the earnings and profits account which attempts to relate the reasons for or against such carrying forward, to an attempt to realize losses or gains actually realized by the parent is unsound. It is not to "save something out of the wreck" that the parent has a right to carry forward a deficit in earnings and surplus. It is because it is the only process by which the financial picture can be preserved on the subsidiary's basis which is essential to the continuity of the corporate life, and ensure not merely the right to recoup operating losses as the subsidiary would have had the right to do, but the right of the government to tax distributions of funds that would have been taxable if distributed by the subsidiary. Neither one nor the other is the sole object or purpose of the *Sansome* rule. That rule is a "two-way" street, not a cul-de-sac as to deficits, and a wide-open highway as to surpluses.[2]

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[1]Similarly, the question of the loss or gain (if any) of a stockholder because of changes in the market value of his stock as the result of the liquidation has no bearing on the question here discussed.

[2]Robert H. Montgomery, well-known authority on federal tax questions, in his "*Federal Tax Handbook*," for 1940-41, referring to the *Sansome* and subsequent cases applying that rule, says (p. 317): "It would seem that the reasoning in the cases just cited would apply with equal force to the continuation in the successor corporation of the operating deficit of the predecessor corporation." And again at p. 472: "When a reorganization has taken place and no gain or loss has been recognized under the Code and prior Acts containing similar reorganization provisions, the bases of the old corporation must be used as the bases of the new corporation for determining gain or loss. . . . It is true that these provisions refer to computations of gain or loss arising from sales, but it would appear that the same rule should apply in computing profits from operations. In consonance with the spirit of the reorganization sections, if deferred credits are to be carried over as liabilities and reported as taxable income, by the same token, deferred debits of all kinds should be carried over as assets and reported as expenses by the new entity. The reasoning of the Circuit Court of Appeals, in the case of Commissioner v. Sansome . . . agrees with the author's construction of the reorganization provisions."

It has been claimed that to allow the deficits to be deducted from the parent's earnings and profits would be to allow a double deduction of these operating losses, once against consolidated income, and once against combined accumulated surpluses.* This would not be a double deduction but would be an adjustment in accord with customary income tax accounting.

Suppose, for example, an enterprise operated as a single corporation carrying on its business in five departments. Four operate at a loss, one at a profit. The operating losses of the four would be deductible for computing the income of the enterprise subject to tax and would also be deducted from the accumulated earnings and profits of the entire enterprise.

Suppose that each of the five departments was a separate wholly owned subsidiary of a parent corporation, and the six corporations together carried on the same enterprise. Under the income tax law permitting consolidated returns, the operating losses of the four unsuccessful corporations would be deducted from the combined income of the enterprise, but the deductions from earnings and profits accounts would be made against the separate earnings and profits accounts of the individual corporations; and it would only be upon liquidation accompanied by the deduction of the deficits from the combined earnings and profits of the enterprise that the true status of the enterprise as a whole would be correctly shown, and shown as it would have been if the enterprise had been operated as a single corporation with several departments instead of in several corporate entities. Since the *Sansome* rule contemplates the continuity of the enterprise it must contemplate the ultimate consolidation of the earnings and profits accounts, whether they show deficits or surpluses.

Furthermore, not to do so is inconsistent with the practice when surpluses exist. Suppose that the four unsuccessful

*The parent and five subsidiaries here involved filed consolidated returns for the years 1918 to 1933 inclusive, but the earnings or losses of the five subsidiaries were not reflected in the parent's surplus prior to Dec. 1, 1936. (R. p. 13.)

subsidiaries operated over several years at a loss after having had a period of successful operations, so that when they were liquidated after the several years of losses, their respective earnings and profits accounts still showed small surpluses. Under the *Sansome* rule these surpluses clearly become surpluses of the parent. During the loss years, however, the operating losses had been taken on the combined income tax return, and also deducted from the several earnings and profits accounts. If the argument based on its claim of double deduction is correct, the losses deducted from the combined income should not be permitted to reduce the combined surpluses after the liquidation. And yet the *Sansome* rule admittedly goes that far.

If it is proper to combine earnings and profits accounts whose balances are the remainders after substantial losses, why is it improper to combine such accounts when some or all of them actually show deficits? It is only a question of degree.

We therefore submit, that from the point of view of sound income tax accounting principles, it is essential that the *Sansome* rule be applied to the earnings and profits accounts of all the liquidated subsidiaries whether they show surpluses or deficits.

4. Congress has accepted and applied the Sansome rule with respect to both surpluses and deficits in earnings and profits accounts.

As this court declared in the *Munter* case, *supra*, the rule of the *Sansome* case, "which for tax purposes treats a reorganized corporation as being a continuation of its predecessors," has repeatedly received Congressional approval as a correct interpretation of the purpose of the tax laws governing reorganizations. The approval so accorded the *Sansome* rule by Congress occurred subsequent to the decision of the *Harter* case, *supra*, which case, as hereinbefore noted, involved application of the *Sansome* rule to a deficit company. The various committee reports hereinafter referred to nowhere indicate any Congressional intention that the *Sansome* rule should apply only to continue the life of a corporation having a surplus, but that the life of a deficit company should not be continued. If Congress intended

that the *Sansome* rule should not consist of the broad principle that the life of a reorganized corporation should be continued in its successor for tax purposes, but on the contrary that the *Sansome* rule should be confined to the narrow rule that a surplus should be carried over to a successor company, then such Congressional intent to so drastically restrict the application of the *Sansome* rule would have been a proper subject for specific legislation. At the least, such an intent would have appeared in Congressional committee reports. No intent to so limit the *Sansome* rule appears. On the contrary, the committee reports, in reference to the statutory provisions relating to the computation of equity invested capital for excess profits tax purposes, made in connection with the 1940 and 1942 Revenue Acts, expressly recognize the propriety of applying the *Sansome* rule to corporations having deficits.

The *Sansome* rule developed originally in connection with tax-free reorganizations. The *Sansome* case was decided on July 26, 1932, and the *Harter* case on July 8, 1935. It was not until January 1, 1936, the effective date of the Revenue Act of 1936, that the liquidation of a wholly owned subsidiary corporation was made tax free. (Sec. 112(b)(6) of the Revenue Act of 1936.)[1] The forerunner of this provision was an amendment to the then pending bill entitled "Revenue Act of 1935" which was introduced by Senator Harrison on August 15, 1935, and which was subsequently enacted as a part of the 1935 Act.[2] Such provision did not, however, become effective since it was superseded by the Revenue Act of 1936.

The reasons for introducing this section were presented by Senator Harrison as to the 1935 Act, and by Senator George as to the 1936 Act, in the following language. The former said (Congressional Record, Vol. 79, p. 13239):

> "I have an amendment to submit that is not a committee amendment, but I have had the clerks work out something with reference to the policy to be ap-

[1] Appendix, p. 43.

[2] 49 Stats. 1014, 1020.

plied to holding companies in case of forced liquidation; and the experts think the amendment I am about to offer is the best that can be drafted."

The next year Senator George referred to the action of Congress in the prior year as follows (Congressional Record, Vol. 80, p. 8799):

> "Section 112(b)(6) of the present law was adopted last year by the Senate, as an amendment to the revenue bill of 1935. It was intended to permit the simplification of our corporate structures, and the liquidation of subsidiaries. * * * The present law requires a new 'basis' for the property of the subsidiary after the property has been taken over by the parent corporation. The protection of the Treasury, as well as sound policy, requires that the property retain the same basis after the liquidation as before."

The matter was again commented upon in Congress in connection with further amendments to this section in the Revenue Act of 1938, concerning which the report of the Senate Finance Committee contained the following statement (Senate Report No. 1567, 75th Congress, Third Session, page 7):[1]

> "The testimony presented to the committee in its hearings reveals that many corporate structures are excessively complicated, that the assets of many personal holding companies and foreign personal holding companies are frozen, and that the utility companies are faced with a death sentence and in addition, with a heavy tax penalty for carrying out the orders of the Federal Government."[2]

In connection with the introduction of this new provision for a tax-free liquidation of a wholly owned subsidiary, and subsequent changes in other provisions of the law relating to the basis of property distributed and the effect of such

[1] Published in Cumulative Bulletin, 1939-1 (Pt. 2), pp. 779, 783.

[2] When Senator Harrison introduced his amendment to the Revenue Act of 1935, on August 15, 1935, there was then pending a bill which was approved on August 26, 1935, and thereupon became law, entitled "Public Utility Holding Company Act of 1935" (15 U.S.C. Ch. 2C). It provided for registration and supervision of holding companies unless exempted by the Securities and Exchange Commission under the conditions set forth in the Act.

liquidations on earnings and profits, Congress apparently took for granted the application of the *Sansome* rule to such transactions. With reference to an amendment to Section 115(h) of the Revenue Act of 1936, relating to the effect of any non-taxable transactions on earnings and profits, the report of the Senate Finance Committee (Senate Report No. 2156, 74th Congress, 2nd Session, page 19)[1] stated:

> "The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a non-taxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in section 115(h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner v. Sansome* (60 Fed. (2d) 931); *United States v. Kauffman*, 62 Fed. (2d), 1045); *Marcheson v. Comm.* (76 Fed. (2d) 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity."

This is the first Congressional statement of the *Sansome* rule and the Committee referred to the leading cases in three Circuit Courts of Appeal where the rule had already been recognized, obviously without endeavoring to cite all cases, including the case of *Hazlet vs. Helvering*, 79 Fed. (2d) 12, decided on July 8, 1935, in the same Circuit as the *Sansome* case.

In connection with another amendment of section 115(h) by the Revenue Act of 1938, expressly providing that a distribution of "property or money" in a non-taxable trans-

[1] Published in Cumulative Bulletin, 1939-1, pp. 678, 690.

action should not constitute a distribution of earnings or profits, the Senate Finance Committee, in its report, again stated that "the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation," referring to the *Sansome* rule as existing law and pointing out that the amendment was made in the interest of added clarity.[1]

Again, when considering the Second Revenue Act of 1940,[2] the House Committee on Ways and Means, in discussing the amendment inserting a new subsection (1) in Section 115 for the purpose of further clarifying the law with respect to what constitutes earnings and profits, as an aid to determining whether distributions are taxable dividends and also determining equity invested capital for excess profits tax purposes, said:[3]

> **"The rule, applied by the Treasury, under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115(h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome* (60 Fed. (2d) 931) and following decisions, the rule effectuates the provisions of section 112."**

The Senate Finance Committee in its report on the same bill expressed the same thought:[4]

> "Under various provisions of the Internal Revenue Code dealing with the exchanges and *liquidations*, the transfer of the property by a corporation to another corporation results in the non-recognition,

[1] Sen. Rept. No. 4567, 75th Cong. 3rd Sess. p. 18 (published in Cumulative Bulletin, 1939-1 (Pt. 2) pp. 779, 792).

[2] Appendix, p. 45.

[3] H. R. Rept. No. 2894, 76th Cong. 3d Sess. p. 41 (published in Cumulative Bulletin, 1940-2, pp. 496, 526).

[4] Sen. Rept. No. 2114, 76th Cong. 3d Sess. p. 25 (published in Cumulative Bulletin, 1940-2, pp. 528, 546).

in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. *These principles are to be given full effect under section 501.* The requirement of section 501 that there shall be no increase *or decrease* in earnings and profits by reason of a wholly unrecognized gain *or loss is but another aspect* of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee." (Emphasis ours.)

In the Second Revenue Act of 1940 (54 Stats. 974, 975) Congress enacted an excess profits tax law. Petitioner argues that the provisions of this law as explained by the reports of the Congressional committees show that Congress interpreted the *Sansome* rule to apply only to surpluses in earnings and profits accounts. With this the respondent emphatically disagrees.

That act levied a tax on excess profits of corporations. One of the provisions granted an exemption from the tax on so much of a corporation's income as equalled a stated percentage of its invested capital. "Invested capital" was then defined in the statute by itemizing the elements which should be included or excluded, in computing such capital.

One of the items included was the following:

> "The accumulated earnings and profits as of the beginning of such taxable year" (Sec. 718(a)(4)).

One of the items excluded was the following:

> "The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in Section 112(b) to (e), both inclusive," etc. (Sec. 718(b)(3)).

Since the greater the invested capital the greater the credit, it was to the interest of the government to make the included items as small as possible and the excluded items as large as possible.

If, in the case of the liquidation of a subsidiary, as in our case, the deficit in its earnings and profits account passes under the *Sansome* rule to the parent and becomes part of its accumulated earnings and profits, then the invested capital of the parent corporation is reduced, the excess profits credit is reduced, and the excess profits tax is *increased*.

The report of the House Committee on Ways and Means on this point says (H.R. Rept. No. 2894, 76th Cong. 3rd Sess. pp. 25, 10 (Cumulative Bulletin, 1940-42, p. 496, at pp. 514, 503)):

> "If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, for the purpose of computing the invested capital for such year."
>
> "Deficits in the earnings and profits account, moreover, do not reduce the invested capital. Nevertheless, deficits in the earnings and profits accounts must be made good out of earnings and profits before any increase in invested capital results from the earnings and profits account."

It is obvious that Congress did not intend to have deficits in earnings and profits accounts enter into the computation of invested capital until capital was completely restored out of future earnings and profits.

If, on the other hand, the liquidation of a subsidiary resulted in transferring to the parent a surplus in the earnings and profits account, the invested capital of the parent would be built up by that transfer. To prevent this Congress enacted the second provision of the statute above quoted. The forerunner of this section was 718(a)(4) of the House bill with regard to which the same committee report says (p. 25 Cumulative Bulletin, p. 514):

> "In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and

> shall be considered to be earnings and profits of the transferee for tax purposes. Subsection (c) (4) of Section 718 provides that such transferred earnings and profits shall *not* be taken into account in computing the earnings and profits as of the beginning of the taxable year for the purpose of determining the equity invested capital. Inasmuch as the property received by the transferee upon such a transfer is included in such cases in the equity invested capital at its adjusted basis in the hands of the transferor, *it is necessary to exclude* the earnings and profits acquired by the transferee by reason of such transfer *in order to avoid duplication.*" (Emphasis ours.)

And the report of the Conference Committee on the same bill (H.R. Rept. No. 3002, 76th Cong. 3rd Sess., p. 49 (Cumulative Bulletin, 1940-2, pp. 548, 555)) sums up both aspects of the situation:

> "The conference agreement also makes further technical changes in order to eliminate duplications in the computation of equity invested capital. Provisions have been inserted governing the extent to which the equity invested capital of a parent corporation is to be *increased or decreased* following a liquidation under section 112(b)(6). This provision enables the provisions of Section 718(b)(3) to be expanded *so as to cover all situations* in which, under the doctrine of *Commissioner v. Sansome*, (60 Fed. (2d), 931), the earnings and profits of one corporation become the earnings and profits of another." (Emphasis ours.)

The purpose of the foregoing provisions of the statute as explained by the committee reports seems to have been to strictly limit the invested capital of every corporation. To do this it was necessary to have the deficits of all merging corporations appear on the balance sheet of the emerging or parent corporation where they would either reduce the parent's earnings and profits, or not be considered at all if the overall figure was a deficit, until the deficit had been restored from earnings and profits. In the meantime they were valued at zero. On the other hand, all surpluses of earnings and profits accounts so received were required to

be eliminated from the computation of invested capital to "avoid duplication." Why then did Congress make special provision only for the elimination of the surpluses? Obviously because it was unnecessary to make a special provision for deficits. Under the *Sansome* rule the deficits automatically passed to the parent or emerging company, as did the surpluses. But it was necessary to insert a special provision to *take out* the surpluses to avoid duplication, because the assets received included the surpluses and were already entered in the computation of invested capital as property received and owned.

The respondent contends, therefore, that the entire Congressional history as revealed by the reports which we have quoted in this section of our brief, clearly show that Congress was fully cognizant of the *Sansome* rule as laid down in the *Sansome*, *Harter*, and subsequent cases, and has approved and applied the rule as construed by respondent herein.[1]

5. The application of the Sansome rule to deficit cases would not lead to tax avoidance or evasion.

Both this Court and Congress have provided rules which will prevent the use of the *Sansome* rule as interpreted in this brief to avoid or evade income taxes. This Court has in other cases involving tax-free changes in corporate relationships required a business purpose and when that requirement is applied to a transaction such as we have in this case, the rule would naturally be governed by such cases as—

Gregory v. Helvering, 293 U.S. 465
Bazley v. Commissioner, 331 U.S. 737
Helvering v. Elkhorn Coal Co. (CCA 4)
95 Fed. (2d) 732, certiorari denied,
305 U.S. 605, 670.

[1] The amendments to the Excess Profits Tax Law made by the Revenue Act of 1942 (56 Stats. 798, 932) entirely changed the theory of determining invested capital in the case of liquidations under Section 112(b)(6) and are not in point.

Section 45 of the Internal Revenue Code gives the Commissioner broad powers to control manipulations of corporate relationships, and in the case of corporations making consolidated returns Section 141 makes special provision for such situations which supplement the provisions of Section 45.[1]

Congress also added Sec. 129[2] to the Internal Revenue Code expressly covering acquisitions of control of corporations or the assets of other corporations with the "principal purpose" of "evasion and avoidance of federal income or excess profits taxes," and providing that deductions arising from such acquisitions should be disallowed.

In the instant case, there is no suggestion that the motive for liquidation was to avoid taxes, or that the subsidiary companies were acquired for that purpose, or that there was anything except a sound business purpose for the liquidation of the five subsidiaries.

CONCLUSION

The underlying principle of the law as stated in Section 112(b)(6) of the Revenue Act of 1936 interpreted by the application of the *Sansome* rule, is therefore, that where a business is a unit, although organized in the form of a group of corporations, the inter-company liquidations shall not be allowed to distort the real financial interests and the economic results of the enterprise. This was the underlying principle behind the "reorganization" provisions of the law from the beginning, and it has since been neither changed nor limited by judicial construction or legislative enactment. The Petitioner should not be allowed to blow hot and cold at the same time—to apply the principle when it produces a taxpaying result and to refuse to apply the same principle when it does not produce a further taxpaying result. Here, Petitioner would require the group to abandon all right (so far as income tax laws are concerned) to recoup the in-

[1] 26 U.S.C. Sections 45, 141.
[2] Appendix, p. 50.

paired capital, and yet insists that all earnings shall fall into the common pot for dividend distribution purposes. Such a result is illogical and unjust and is contrary to convincing judicial precedent which originated, developed and applied the *Sansome* principle and to sound principles of income tax accounting.

The decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX

1. REVENUE ACT OF 1936, c. 690, 49 Stat. 1648:

Sec. 22. Gross Income.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

. . . . . .

Sec. 112. Recognition of Gain or Loss.

. . . . . .

(b) *Exchanges solely in kind.*—

. . . . . .

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. . . .

. . . . . .

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

(15) *Property received by a corporation on complete liquidation of another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor.

. . . . . .

Sec. 115. Distributions by Corporations.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203(a)(3)

and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113:

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in *another* corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

2 REVENUE ACT OF 1938, c. 289, 52 Stat. 447:

SEC. 115. Distributions by Corporations.

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1933, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

"(1) if no gain to such distributee from the receipt of such stock or securities, property, or money, was recognized by law; or

"(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution, or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

3. SECOND REVENUE ACT OF 1940, c. 757, 54 Stat. 974:

Sec. 501. Earnings and Profits of Corporations.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis

(under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where, in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received."

(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U.S.C. 1940 ed., Sec. 115.)

4. TREASURY REGULATIONS 94, promulgated under the Revenue Act of 1936:—

Art. 115-3. *Earnings or profits.* In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

Art. 115-11. *Effect on earnings or profits of certain tax free exchanges and tax free distributions.* If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115(c) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of

stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

* * * * * * *

TREASURY REGULATIONS 101, (promulgated under the Revenue Act of 1938):

Art. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall

be made, as between the transferor and transferee corporations.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization —

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year beginning before January 1, 1938 (or on or after such date) in exchange for its stock or securities (see section 112(b)(3)) if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under circumstances described in section 112(b)(6) of the Revenue Act of 1936 or section 112(b)(6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 374 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

* * * * * * *

6. INTERNAL REVENUE CODE, Sec. 129 (26 U.S.C. 1945 Ed., Sec. 129):

"*Sec. 129. Acquisitions made to evade or avoid income or excess profits tax*

(*a*) *Disallowance of deduction, credit, or allowance.* If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote, or at least 50 per

centum of the total value of shares of all classes of stock of the corporation.

(b). Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income; and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2)."